Georgia Tech Financial Analysis Lab
800 West Peachtree Street NW
Atlanta, GA 30332-0520
404-894-4395
http://www.mgt.gatech.edu/finlab

Dr. Charles W. Mulford, Director
Invesco Chair and Professor of Accounting
charles.mulford@mgt.gatech.edu

Scott Bouchette
MBA Student
scott.bouchette@mba.gatech.edu

FINANCIAL STATEMENT COMPARABILITY IN A PRINCIPLES-BASED REPORTING ENVIRONMENT: A LOOK AT THE STATEMENT OF CASH FLOWS

EXECUTIVE SUMMARY

In this research report we look at how U.S. companies might prepare financial statements in a principles-based accounting environment and how comparability of financial statements may be affected. We identify the statement of cash flows as a principles-based financial statement where only limited reporting rules are provided and use it to analyze how different companies are currently reporting similar transactions in a principles-based setting. We then use the results to comment on how U.S. companies might prepare their financial statements under principles-based standards and how overall comparability might be affected.

We look at four types of transactions, book overdrafts, sale and leaseback transactions, capitalized software costs and short-term investments, and find that companies are not consistent in their classification of cash flows. This lack of consistency is due to the principles-based nature of the cash flow statement and the associated lack of rules-based guidance. Due to the lack of consistency, it is difficult to compare among companies an important performance metric, cash provided by operating activities. This lack of comparability could be expected to extend to other financial statements in a principles-based environment.

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Georgia Tech Financial Analysis Lab
College of Management
Georgia Institute of Technology
Atlanta, GA 30332-0520

Georgia Tech Financial Analysis Lab

The Georgia Tech Financial Analysis Lab conducts unbiased stock market research. Unbiased information is vital to effective investment decision-making. Accordingly, we think that independent research organizations, such as our own, have an important role to play in providing information to market participants.

Because our Lab is housed within a university, all of our research reports have an educational quality, as they are designed to impart knowledge and understanding to those who read them. Our focus is on issues that we believe will be of interest to a large segment of stock market participants. Depending on the issue, we may focus our attention on individual companies, groups of companies, or on large segments of the market at large.

A recurring theme in our work is the identification of reporting practices that give investors a misleading signal, whether positive or negative, of corporate earning power. We define earning power as the ability to generate a sustainable stream of earnings that is backed by cash flow. Accordingly, our research may look into reporting practices that affect either earnings or cash flow, or both. At times, our research may look at stock prices generally, though from a fundamental and not technical point of view.

Contact Information

Charles Mulford	Invesco Chair, Professor of Accounting and the Lab's Director Phone: (404) 894-4395 Email: charles.mulford@mgt.gatech.edu
Elizabeth Thomson	Graduate research assistant and MBA student
James Jayko	Graduate research assistant and MBA student
Mark Gram	MBA Student
Scott Bouchette	MBA Student
Ryan Swanson	MBA Student

Website: http://www.mgt.gatech.edu/finlab

Companies Named in this Report

Financial Statement Comparability in a Principles-Based Reporting Environment: A Look at the Statement of Cash Flows

Important Findings

- SFAS No. 95, The Statement of Cash Flows, provides limited rules-based guidance for the classification of cash flows (we consider it a principles-based standard).

- Companies are not consistent in their classification of cash flows from operations and from investing and financing cash flows resulting from book overdrafts, sale and leaseback transactions, capitalized software and short-term investments

- The lack of consistency in the classification of cash flows might be expected to carry over to the other financial statements if the U.S. were to adopt a principles-based approach to accounting. As a result, the comparability of financial statements among different companies could be affected.

Introduction

Rules-based or principles-based standards? This is an important question facing the accounting profession today. The answer will likely have major implications for companies preparing financial statements in the United States. U.S. Generally Accepted Accounting Principles (GAAP) are a rules-based set of standards while International Financial Reporting Standards (IFRS) take a more principles-based approach. Currently, all companies listed on U.S. stock exchanges are required to prepare their financial statements according to GAAP or reconcile them to GAAP if they use another set of standards.[1] There is growing sentiment in the U.S. to adopt the more principles-based approach that is catching on in much of the world either by converging GAAP with IFRS or by allowing U.S. companies to choose which standards (GAAP or IFRS) to use for reporting.[2]

The objective of this research report is to determine how adopting a principles-based approach to accounting in the U.S. might affect comparability among the financial statements of different companies. We have identified the statement of cash flows as being a principles-based statement and use it to analyze how similar transactions are accounted for by different firms. In particular, we look at how different companies account for book overdrafts, proceeds from sale and leaseback transactions, capitalized software costs and short-term investments on the statement of cash flows. We use our analysis of the statement of cash flows to comment on how U.S. companies might report in a more principles-based environment and how comparability may be impacted.

Principles versus Rules-Based Standards

An excellent description of the difference between principles and rules-based standards is that "principles-based accounting provides a conceptual basis for accountants to follow instead of a detailed list of rules."[3] The critics of rules-based accounting point out companies often use the rules to structure transactions in a way that meets their preference as opposed to economic reality. They may be abiding by the rule, but they are not abiding by its intent.[4]

Many positives are detailed when discussing the virtues of the principles-based approach to accounting including better reporting transparency and quicker response to emerging issues.[5] Another positive frequently mentioned is increased comparability between the financial statements of different companies and different countries. Would a principles-based approach to accounting truly improve comparability?

[1] The SEC is considering eliminating the reconciliation requirement for non U.S. companies reporting under IFRS.
[2] Donna Block, "Minding the GAAP," *TheDeal.com*, March 19, 2007.
[3] Rebecca Toppe Shortridge and Mark Myring, "Defining Principles-Based Accounting Standards," *The CPA Journal Online*, http://www.nysscpa.org/cpajournal/2004/804/essentials/p34.htm, accessed April 11, 2007.
[4] Lawrence Revsine, Daniel A. Collins, and W. Bruce Johnson, *Financial Reporting and Analysis*, 3rd ed. (Upper Saddle River, NJ: Prentice Hall, 2005), p. 1013.
[5] "Principles-Based Accounting: Will they or won't they?," *The Accountant*, March 30, 2007.

Statement of Cash Flows

The Financial Accounting Standards Board (FASB) has the responsibility to "establish and improve standards of financial accounting and reporting" in the United States.[6] One way the FASB establishes the standards is by issuing Statements of Financial Accounting Standards (SFAS) which, once issued, become part of U.S. GAAP. In November 1987, the FASB issued SFAS No. 95, *Statement of Cash Flows*. This standard requires all companies to include a statement of cash flows as an integral part of their financial statements.

The statement of cash flows requires companies to "classify cash receipts and payments according to whether they stem from operating, investing, or financing activities."[7] The standard goes on to define cash inflows and outflows for each of the three activities. We discuss these definitions in more detail as we begin to analyze specific transactions.

Nearly all of the requirements and guidelines for the statement of cash flows are contained within SFAS No. 95. Other than some minor amendments due to subsequent standards, there is no additional guidance on the statement of cash flows.[8] Due to the limited amount of specific rules-based guidance available we have classified the statement of cash flows as a principles-based financial statement. Management must read the standards and use their judgment as to how the specific cash flows should be classified.

Blockbuster and Netflix - An Example

Assume that an investor is looking to purchase stock in a video rental company. One company receiving consideration is Blockbuster Inc. According to its latest 10-K, "Blockbuster Inc. is a leading global provider of in-home rental and retail movie and game entertainment."[9] Netflix Inc., "the largest online movie rental subscription service"[10] also shows up on the investor's list of target companies. For the purposes of this example we assume that this investor has narrowed his investment options down to these two companies.

Assume that one measure the investor uses as part of his analysis is operating cash flow. He notes that Blockbuster's net cash flow provided by operating activities was $329.4 million in 2006.[11] Comparatively, Netflix had reported net cash flow provided by operating activities of $247.9 million during the same period.[12] Looking closer, the investor notices a difference. Blockbuster has included an item called "rental library purchases" in the operating activities section of the statement of cash flows. Netflix includes a similar item called "acquisitions of DVD library" under investing activities.

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[6] "The Mission of the Financial Accounting Standards Board," http://www.fasb.org/facts/, accessed April 11, 2007.
[7] "Statement of Financial Accounting Standards No. 95," http://www.fasb.org/pdf/fas95.pdf, accessed April 15, 2007.
[8] "Status of Statement No. 95," http://www.fasb.org/st/status/statpg95.shtml, accessed April 15, 2007.
[9] Blockbuster Inc. 10-K, March 1, 2007, p. 1.
[10] Netflix Inc. 10-K, December 31, 2006, p. 1.
[11] Blockbuster Inc. 10-K, March 1, 2007, p. 69.
[12] Netflix Inc. 10-K, December 31, 2006, p. F-7.

The investor realizes that the two operating cash flow measures are not comparable as reported. In order to get a true comparison, the investor must take the operating cash flow number reported by Netflix ($247.9 million) and subtract the amount associated with the "acquisitions of DVD library" ($169.5 million). The investor now shows adjusted net cash flows from operating activities of $78.4 million for Netflix. He can now compare this number with Blockbuster's ($329.4 million) for a more accurate picture of the companies' operating cash flows.

This example shows how different companies operating in the same industry have made different judgments on cash flow classification. We now take a look at a number of other transactions. We examine how the sample companies have classified the cash flows associated with the transactions and how their classification has affected comparability.

Book Overdrafts

Book overdrafts occur when a company has "uncleared checks in excess of cash balances in the related bank accounts."[13] In essence, they are short-term loans provided to a company by a financial institution. According to SFAS No. 95, cash flows from "financing activities include…borrowing money and repaying amounts borrowed, or otherwise settling the obligation."[14] SFAS No. 95 goes further by stating cash inflows from financing activities include "proceeds from issuing bonds, mortgages, notes and from other short- or long-term borrowing" and cash outflows include "repayments of amounts borrowed."[15] Based on these definitions, it would appear that book overdrafts are more consistent with a financing classification on the statement of cash flows. It should be noted, however, that SFAS No. 95 does not specify how cash flows related to book overdrafts should be classified.

Exhibit 1 shows a list of companies that account for overdrafts in the financing activities section of the statement of cash flows.

Exhibit 1: Change in Book Overdrafts Included in Financing Activities of the Statement of Cash Flows

Company	Fiscal YE	Change in Overdraft Amnt	Reported Operating CF	Reported Financing CF
Synnex Corp	11/30/06	($20,271,000)	($18,939,000)	$58,626,000
Chattem Inc	11/30/06	$5,824,000	$54,422,000	($4,149,000)
Trueyou.com	7/1/06	($163,000)	($22,277,000)	$30,836,000

Earlier we mentioned that the statement of cash flows is a principles-based financial statement. Instead of providing companies with a list of rules to determine how to classify the cash flows from each transaction, companies must use their judgment to determine whether a transaction should be classified as operating, investing, or financing. Accordingly, Exhibit 2 provides a list of companies that account for overdrafts in the operating section of the statement of cash flows. In the Exhibit we adjust operating cash flow to make it comparable with the firms in Exhibit 1 where overdrafts were reported in financing cash flow.

[13] PetSmart Inc. 10-K, January 28, 2007, p. F-8.
[14] "Statement of Financial Accounting Standards No. 95," http://www.fasb.org/pdf/fas95.pdf, accessed April 15, 2007.
[15] Ibid.

Exhibit 2: Change in Book Overdrafts Included in Operating Activities of the Statement of Cash Flows

Company	Fiscal YE	Change in Overdraft Amnt	Reported Operating CF	Adjusted Operating CF	% Chng OCF	Reported Financing CF	Adjusted Financing CF
AMCON Distributing Co	9/30/06	($600,000)	($343,321)	$256,679	174.76%	$843,671	$243,671
Central Parking Corp	9/30/06	($1,500,000)	($2,063,000)	($563,000)	72.71%	($85,705,000)	($87,205,000)
Guitar Center Inc	12/31/06	$1,761,000	$23,344,000	$21,583,000	-7.54%	$83,574,000	$85,335,000

The companies in Exhibit 1 and Exhibit 2 were provided the same guidance in the form of SFAS No. 95, but each group has interpreted the standard differently. An investor interested in analyzing operating cash flow would first need to adjust the reported operating cash flow for the companies in Exhibit 2 by the amount of the change in overdraft (which we have done in the "Adjusted Operating CF" column) before he or she could truly compare the results of the companies in the two exhibits. More importantly, the investor would need to know there was a need to adjust the cash flows to account for the differences in overdraft classification. For example, an investor looking at AMCON Distributing Co. might be surprised to find out that the reported negative operating cash flow is actually positive when adjusted for the decrease in book overdrafts.

Sale and Leaseback Transactions

A sale and leaseback transaction is a "transaction in which the owner of a property sells the property to another and simultaneously leases it back from the new owner."[16] For example, suppose Company A owns an office building and is in need of cash. Company A sells the office building to Company B for $10,000,000. At the same time, Company A enters into a lease agreement with Company B for the right to continue to use the office building. In this example, Company A entered into a sale and leaseback transaction for financing purposes.

From the lessee's perspective there are two types of leases, capital leases and operating leases. Capital leases are required to be recorded on the lessee's balance sheet while operating leases are disclosed in the notes to the financial statements, but not on the balance sheet. SFAS No. 13, *Accounting for Leases*, provides four criteria for determining whether the lease is classified as a capital or operating lease. If the lease "transfers ownership of the property to the lessee at the end of the lease term, contains a bargain purchase option, [has a term that] is equal to 75 percent or more of the estimated economic life of the leased property" or if the "present value at the beginning of the lease term of the minimum lease payments…equals or exceeds 90 percent" of the fair market value of the property, the lease must be classified as a capital lease.[17] All other leases are classified as operating.

Proceeds from sale and leaseback transactions in which the lease is classified as a capital lease are recorded as financing activities on the statement of cash flows. However, there is no similar guidance for leasebacks classified as operating leases. Based on our research, companies are not consistent in their classification of proceeds from sale and leaseback transactions where the

[16] Donald E. Kieso, Jerry J. Weygandt, and Terry D. Warfield, *Intermediate Accounting*, 12th ed. (Hoboken, NJ: John Wiley & Sons, 2007), p. 1128.

[17] "Statement of Financial Accounting Standards No. 13," http://www.fasb.org/pdf/fas13.pdf, accessed April 21, 2007.

leaseback is classified as an operating lease. For this reason, we concentrate on operating leases. SFAS No. 95 does not provide specific guidance on how proceeds received in a sale and leaseback transaction with an operating leaseback should be classified. Based on the definitions discussed earlier, we feel that proceeds from sales and leaseback transactions should be classified as financing activities on the statement of cash flows. Exhibit 3 presents two companies that record the proceeds from such transactions as financing cash flow.

Exhibit 3: Sale and Leaseback Proceeds Reported in Financing Activities of the Statement of Cash Flows

Company	Fiscal YE	Sale/Leaseback Procceeds	Reported Investing CF	Reported Financing CF
Dayton Superior Corp	12/31/05	$23,180,000	($16,372,000)	$9,085,000
Res Care, Inc	12/31/06	$2,651,000	($102,384,000)	$61,791,000

In contrast to the firms listed in Exhibit 3, many companies classify sale and leaseback proceeds as investing cash flow. Exhibit 4 provides a sample of these companies. In the Exhibit we adjust investing cash flow to move the sale and leaseback proceeds to financing cash flow.

Exhibit 4: Sale and Leaseback Proceeds Reported in Investing Activities of the Statement of Cash Flows

Company	Fiscal YE	Sale/Leaseback Proceeds	Reported Investing CF	Adjusted Investing CF	Reported Financing CF	Adjusted Financing CF
American Pacific Corp	9/30/06	$2,395,000	($121,045,000)	($123,440,000)	$81,214,000	$83,609,000
CA, Inc	3/31/06	$75,000,000	($847,000,000)	($922,000,000)	($1,468,000,000)	($1,393,000,000)
Dicks Sporting Goods	2/3/07	$24,809,000	($169,191,000)	($194,000,000)	$72,353,000	$97,162,000
Rite Aid Corp	3/4/06	$77,307,000	($231,084,000)	($308,391,000)	($272,835,000)	($195,528,000)
Tweeter Home Entertainment	9/30/06	$13,521,951	($3,360,530)	($16,882,481)	($12,224,620)	$1,297,331

Proceeds from sale and leaseback transactions provide an example of the difficulties that exist in comparing financial performance among companies based on their cash flow statement. For example, Tweeter Home Entertainment shows negative financing cash flow of over $12 million, but this is adjusted to positive cash flow of over $1 million if the proceeds from the sale and leaseback are reclassified to financing activities. An investor would need to make this adjustment before comparing Tweeter with any of the companies listed in exhibit 3.

The classification of cash flows associated with a sale and leaseback transaction also has an impact on free cash flow. Free cash flow is another important measure used by investors to compare companies and evaluate financial performance. It can help determine how much cash a company has available to "finance further expansion of operating capacity, reduce debt, pay dividends or repurchase stock."[18] We calculate free cash flow as operating cash flow minus capital expenditures, net of dispositions. Capital expenditures are measured net of dispositions to determine the incremental resources needed to add to a company's fixed asset base. When calculating free cash flow for a company with proceeds from a sale and leaseback transaction reported in investing cash flow, it is important to adjust net capital expenditures. Sale and leaseback transactions entail sales of fixed assets that do not reduce a company's fixed asset base. As such, their proceeds should not be used to reduce net capital expenditures. Therefore the proceeds from sale and leaseback transactions should be backed out of the net capital

[18] Lawrence Revsine, Daniel A. Collins, and W. Bruce Johnson, *Financial Reporting and Analysis*, 3rd ed. (Upper Saddle River, NJ: Prentice Hall, 2005), p. 274.

expenditures, increasing them. This adjustment reduces free cash flow. Exhibit 5 shows adjusted free cash flow calculations for the companies previously listed in Exhibit 4.

Exhibit 5: Adjusted Free Cash Flow Calculations for Sale and Leaseback Transactions

Company	Fiscal YE	Operating CF	CAPX net of Dispositions including Sale & Leaseback Proceeds	FCF Including Sales & Leaseback Proceeds	Sale and Leaseback Proceeds	FCF excluding Sale & Leaseback proceeds
American Pacific Corp	9/30/06	$9,490,000	($12,623,000)	($3,133,000)	$2,395,000	($5,528,000)
CA, Inc	3/31/06	$1,380,000,000	($66,000,000)	$1,314,000,000	$75,000,000	$1,239,000,000
Dicks Sporting Goods	2/3/07	$196,216,000	($165,470,000)	$30,746,000	$24,809,000	$5,937,000
Rite Aid Corp	3/4/06	$417,165,000	($184,123,000)	$233,042,000	$77,307,000	$155,735,000
Tweeter Home Entertainment	9/30/06	$15,570,825	($3,835,033)	$11,735,792	$13,521,951	($1,786,159)

Capitalized Software Costs

Software companies are given an option of whether or not to capitalize a portion of their software development costs. SFAS No. 86, *Accounting for the Costs of Computer Software to be Sold, Leased, or Otherwise Marketed* defines which costs should be expensed and which can be capitalized. According to the standard, all software development costs must be expensed until technological feasibility of the product is established. From that point, companies then capitalize software development costs for the product until the product is ready for general release to the public.[19]

Many companies in this industry expense all of their software development costs. Companies that expense all of their software development costs generally reference the small time frame between when the product's technological feasibility is reached and when it is released to the public as the main reason. That is, software costs that are incurred after technological feasibility is reached are considered to be immaterial. Exhibit 6 shows a list of companies that expense all of their software development costs.

Exhibit 6: All Software Development Costs Expensed

Company	Fiscal YE	Amount Expensed	Reported Operating CF	Reported Investing CF
Electronic Arts Inc	3/31/06	$758,000,000	$596,000,000	($108,000,000)
Lawson Software Inc	5/31/06	$60,711,000	$76,486,000	($23,758,000)
Symantec Corporation	3/31/06	$664,628,000	$1,536,896,000	$3,619,605,000

By virtue of including the costs in operating expenses, when a company expenses all of its software development costs, it reports their cash flow effects as operating cash flow. In contrast, when software costs are capitalized, there is no specific accounting guidance on how the cash

[19] "Statement of Financial Accounting Standards No. 86," http://www.fasb.org/pdf/fas86.pdf, accessed April 22, 2007.

flow effects of such expenditures should be classified. As a result, some companies report them as operating cash flow while others use an investing designation.

Exhibit 7 contains a list of companies that report capitalized software costs as operating cash flows.

Exhibit 7: Capitalized Software Development Costs Included in Operating Activities of the Statement of Cash Flows

Company	Fiscal YE	Amnt Capitalized	Reported Investing CF	Reported Operating CF
Activision	3/31/06	$193,927,000	($85,796,000)	$86,007,000
Midway Games Inc	12/31/06	$69,342,000	($8,676,000)	($92,902,000)
Take-Two Interactive Software, Inc	10/31/06	$133,646,000	($25,275,000)	$43,362,000
THQ Inc	3/31/06	$134,943,000	($85,882,000)	$42,789,000

The classification of capitalized software development costs as operating cash flow is consistent with firms that expense their software costs as incurred. In addition, operating treatment provides for a direct comparison of operating cash flow with the companies that expense software development costs. In contrast, however, the companies listed in Exhibit 8 have classified their capitalized software development costs as investing cash flow. In the Exhibit we adjust operating and investing cash flow for the amount of capitalized software development costs.

Exhibit 8: Capitalized Software Development Costs Included in Investing Activities of the Statement of Cash Flows.

Company	Fiscal YE	Amnt Capitalized	Reported Operating CF	Adjusted Operating CF	% Chng OCF	Reported Investing CF	Adjusted Investing CF
BISYS Group Inc	6/30/06	$7,419,000	($34,903,000)	($42,322,000)	-21.26%	$412,021,000	$419,440,000
Spescom Software Inc	9/30/06	$35,000	($773,000)	($808,000)	-4.53%	($78,000)	($43,000)
Synopsys Inc	10/31/06	$2,946,000	$205,890,000	$202,944,000	-1.43%	($153,777,000)	($150,831,000)
Verifone Holdings, Inc	10/31/06	$1,999,000	$16,747,000	$14,748,000	-11.94%	($4,025,000)	($2,026,000)

An investor wanting to compare the operating cash flow of the companies listed in Exhibit 8 with those listed in both Exhibits 6 and 7 would first have to adjust the reported operating cash flow number for the effects of the capitalized software development costs (we have done this in the "Adjusted Operating CF" column of Exhibit 8). Once again, the investor would also have to recognize the need to make the adjustment based on differences in how cash flows for software costs have been reported.

Short-Term Investments

Short-term investments are "temporary investment[s] of otherwise idle cash in marketable securities."[20] Companies can classify short-term investments as held-to-maturity, trading or available-for-sale. If a company classifies the short-term investments as either held-to-maturity or available-for-sale, the cash flow effects are reported as investing activities on the statement of

[20] Charles T. Horngren, Gary L. Sundem, John A. Elliott, and Donna R. Philbrick, *Introduction to Financial Accounting*, 9th ed. (Upper Saddle River, NJ: Prentice Hall, 2006), p. 494.

cash flows. When classified as trading, however, the cash flow effects are reported as operating activities. Companies must use their judgment when classifying short-term investments.

Typically, non-financial companies do not actively trade short-term investments as financial firms do. In fact, most non-financial companies use short-term investments to "park" excess funds, awaiting anticipated needs. As such, the classification of these investments as trading, with the accompanying cash flow effects reported as operating cash flow, is not in keeping with the economic nature of these funds. Exhibit 9 provides a list of non-financial companies that have classified their investments as trading, and thus reported the cash flow effects as operating activities. We have adjusted operating cash flow for the cash flows associated with these short-term investments.

Exhibit 9: Short-Term Investments Reported in Operating Activities of the Statement of Cash Flows

Company	Fiscal YE	Proceeds on (Purchases of) ST Investments	Reported Operating CF	Adjusted Operating CF	% Chng OCF
American Software, Inc	4/30/06	($1,140,000)	$10,540,000	$11,680,000	10.82%
Aphton Corp	12/31/05	$7,599,211	($34,041,786)	($41,640,997)	-22.32%
Repros Therapeutics Inc	12/31/06	$9,067,000	($983,000)	($10,050,000)	-922.38%

Repros Therapeutics Inc. is a "development stage biopharmaceutical company focused on the development of new drugs to treat hormonal and reproductive system disorders."[21] Notice, however, that their reported operating cash flow of negative $983,000 includes over $9 million worth of proceeds from sales of short-term investments classified as trading securities. Because this company is not a financial institution, and there is no evidence that the firm makes a business of buying and selling securities, we have adjusted their reported operating cash flow to remove the trading-security proceeds. The adjusted operating cash flow for Repros Therapeutics Inc. is over 900 percent lower than the reported amount. The lack of rules-based guidance allowed the company, and others, the flexibility to choose how short-term investments were classified. This classification can significantly alter amounts reported as and investing cash flows.

Conclusion

The lack of rules-based guidance provided by U.S. GAAP for the statement of cash flows leads different companies to make different judgments on how the cash flow effects of certain transactions are classified. This flexibility hurts the ability of an investor to compare directly the statement of cash flows of multiple companies. Moving from a set of rules-based standards to principles-based standards would be expected to spread this flexibility to other financial statements as well. Our research, based on the statement of cash flows, shows that a principles-based set of standards may lead to a lower level of comparability among the financial statements of reporting companies.

[21] Respros 10-K, December 31, 2006, p. 2.